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ABSTRACT

This booklet and the training program provide a strategy to effect compliance with the Internal Revenue Service (IRS) guidelines where the parties (the employers, the employee, and the Service Provider) agree to take responsibility for the matters over which each has control. This approach minimizes the risk to employers who voluntarily offer tax-sheltered annuity programs to employees and holds each party appropriately accountable for any violations to IRS statues. The guide contains programs and compliance regulations; the compliance booklet, an overview of 403(b) arrangements; the IRS audit program; and other materials concerning compliance, retirement programs, and retirement plans for public school organizations. (DFR)

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A Guide To §403(b) Tax Deferred Retirement Plan Compliance For School Organizations

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A Guide to §403(b) Tax Deferred Retirement Plan Compliance for School Organizations

Second Edition

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§403(b) Programs and Compliance

Why has ASBO prepared a compliance booklet for school business officials?

For many years, the Internal Revenue Service (IRS) gave little attention to 403(b) tax-sheltered annuity (TSA) programs in the form of audits or other examinations, probably because such "plans" are informal arrangements. For example, unlike qualified ERISA plans, there is no filing of the annual form 5500, which contributes to the difficulty in identifying a 403(b) plan. Regardless of the explanation, the IRS simply did not give much attention to compliance issues for tax-sheltered annuity programs or to the procedures necessary to correctly administer a 403(b) program.

That changed in 1992 when the IRS began general audits of tax-exempt organizations. As part of these general audits, the IRS instructed its agents to examine the status of retirement plans, including 403(b) plans. Because those audits revealed that many 403(b) programs were not in compliance with the regulations, audit guidelines specific to 403(b) programs were issued on May 8, 1995 (Announcement 95-33). Field examiners were then trained on 403(b) compliance issues and directed to begin testing the audit guidelines by conducting audits. The IRS compliance program on 403(b) programs has been enhanced to include annual training sessions for field examiners on TSA audit issues. The product of this effort has been more audits of 501(c)(3) organizations such as hospitals, colleges, and universities as well as public school entities.

The Association of School Business Officials (ASBO) International is responding to the need to provide compliance information to its members followed with training sessions arranged through affiliate organizations. The training sessions are provided as a way for school business officials and their staff members to gain an understanding of the TSA audit issues and compliance procedures along with an opportunity to ask questions.

A number of TSA vendors are involved in this effort to provide technical assistance for compliance information and training support. This effort by ASBO is primarily designed to reduce the complexity and to simplify the administration of TSA programs. This will help school officials manage the risk of TSA programs as well as protect both employers and employees of public school organizations. Many of the plan defects that surfaced in IRS audits, which are explained in the section titled "The Internal Revenue Service Audit Program", cannot be corrected by the employer since most 403(b) programs are voluntary arrangements where each employee controls his or her own individual 403(b) account. For example, the employee deals directly with the service provider regarding distributions and loans. The employer is not directly involved in any way.

This booklet and the training program provides a strategy to effect compliance with IRS guidelines where the parties (the employer, the employee, and the Service Provider) agree to take responsibility for the matters over which each has control. This approach will minimize the risk to employers who voluntarily offer TSA programs to employees and will hold each party appropriately accountable for any violations to IRS statutes.

What does the IRS plan hold for the future?

The IRS plans to issue new examination guidelines that will include legislation that was passed after the 1995 guidelines were issued and that incorporate changes that have been suggested due to the "testing" of the 1995 guidelines. Most importantly for public school entities, the IRS intends to continue their audit program of tax-exempt organizations. However, they also plan to expend resources for educational programs, available to groups such as ASBO and the

organizations that either administer or market 403(b) plans. We believe that the new examination guidelines will be issued sometime in 1999; however, we do not expect the new guidelines to contain changes that would substantially modify the information in this booklet or the educational programs of ASBO.

We do not know how many public schools will be selected for audit in the coming years; however, we do know that the IRS National Office has "suggested" to their field offices that a minimum of five audits of public schools be done by each of the four district offices. The IRS is quick, however, to point out that field examiners have autonomy and may choose to conduct more or less than the suggested number. We also know that public school audits have been more frequent in certain regions of the country than in others. What is most clear is that the IRS has committed substantial resources to the training of agents. It is certainly with the expectation that there will be a significant increase in the audit effort on TSA programs in school entities.

What has happened in those public schools that have been audited?

The IRS does not share or disclose specific information about audit results; however, information about such audits of public schools, partially from general IRS statements about the audits, reveals that the most common violations to date have been:

1. *Contributions made in excess of the maximum annual limits.*

This violation has resulted in the school district paying assessments for the under withholding of federal income taxes and, correspondingly, under withholding state income taxes where there are state taxes. In such instances, the IRS has been supportive of efforts to collect the taxes from each individual employee for whom payment was remitted. However, the collection of those taxes from individual employees has been problematic, especially when the involved employee has separated from service with the specific school district.

2. *Violation of the nondiscrimination rules.*

As further explained in this booklet, if 403(b) programs are made available to any employee in the school entity, then the opportunity to make TSA investments must generally be made available to all employees with few exceptions. However, the IRS has found violations for the failure to make the TSA programs available to eligible employees including certain substitute teachers and employees who want to contribute relatively small amounts.

The other problem encountered by school entities that have been audited has been the heavy administrative burden of an audit. Field examiners require the school entity to provide dedicated office space, equipment, and almost constant support by school staff. The expense of this type of support to examiners can be very significant.

Suppose a school entity wants to stave off an audit through correction of known plan defects?

There are formal and informal programs for public schools that want to correct known plan defects. The formal program for employers is referred to as TVC, the Tax-Sheltered Annuity Voluntary Correction Program, which was first implemented in 1995, then extended through December 31, 1998, under which employers can apply for formal correction of defects. As of July 1998, 110 employers including public education institutions and 501(c)(3) organizations have submitted plans for formal correction. Of those, 55 have been "settled", and it appears that IRS assessments have averaged 10% of the sanctions that might have occurred if the defects were discovered upon audit. A newly written TVC is expected in 1999. It likely will contain a specific schedule of sanctions for specific defects. This increases the probability that some employers will seriously consider voluntary correction because of the ability to know in advance the magnitude of the sanctions. Once the new TVC has been officially issued, it will be reported out in publications of ASBO, and will also be discussed in the educational sessions conducted by various affiliates.

There is also an "informal"

voluntary correction directive referred to as the Administrative Policy Regarding Self-Correction which was issued on January 7, 1997. This directive replaces a prior administrative directive, which did not include guidance on 403(b) programs to field examiners who are approached by employers who want to self-correct certain types of TSA defects. Currently, there is not a great deal of information available on the new policy; however, the IRS has indicated that guidance will soon be forthcoming as one method of helping employers who do not want to enter the formal correction program (TVC).

My school district has adopted the standardized Salary Reduction Agreement, as well as the Service Provider Agreement, which was a part of the original compliance booklet. However, a number of the product providers and mutual fund vendors have refused to sign the Service Provider Agreement. How have school entities confronted this situation?

It has been mixed; however, the trend toward the eviction of providers that will not sign the Service Provider Agreement, or otherwise cooperate in compliance activities, is growing. On the other hand, there are many school districts that have not made the decision to evict. As of this writing, thirty-two insurance companies, major marketing firms, and large mutual fund broker/dealers have indicated that either or both of the forms are acceptable to them. We expect the acceptance of the forms by service providers to increase, especially if school entities continue the process of evicting those who will not cooperate. With the large number of service providers who have agreed to cooperate with the encouragement of the National Tax Sheltered Annuity Association (NTSAA), it now appears that there is a very wide range of investment options which would be available to employees, including fixed annuities, variable annuities, and mutual funds.

The school entities that have been successful in evicting providers have indicated that open communications with unions and employees early in the process was essential. If unions are brought into discussions early, and affected employees are made aware of what is happening and why it is happening, there appears to be greater acceptance and fewer problems. It is very important that employees understand that certain actions are required to comply with federal tax law as well as to protect the employer and the employee.

One school district notified employees that certain service providers would not execute the required agreements. In this specific instance, those service providers who initially would not sign the standardized agreements were provided more time to comply. Employees were informed that if the service providers failed to comply within the time extension that the school entity would have no choice but to terminate the payroll privilege. This communication prepared employees in advance of the final eviction process. Another school entity terminated the payroll privilege for new participants, but allowed those who were currently contributing to non-compliant providers to continue those contributions for a period of time to allow employees ample opportunity to redirect contributions to those vendors who agreed to comply.

Finally, some school entities have obtained signed Service Provider Agreements from those willing to sign, and have waived the requirement for those who were not willing to sign. It is unlikely that this approach will be effective, especially since some of those service providers who cooperated have included a caveat to the forms that any liabilities would apply to the providers only to the extent they apply to all of the approved providers in that district.

The Compliance Booklet

The compliance booklet provides a basic overview of 403(b) plans including a list of IRS compliance issues taken from the Examination Guidelines that are directly applicable to public education institutions. The booklet also contains recommendations to provide effective protection for employers as well as employees, sample forms (Salary Reduction Agreement and Service Provider Agreement) and a compliance checklist intended to provide

some basic guidance for the correct administration of 403(b) programs and to help avoid program defects. Only those issues that are specific to public education institutions are covered in this booklet. Issues that apply to other 501(c)(3) organizations are not addressed here.

An Overview of 403(b) Arrangements

Section 403(b) arrangements are commonly referred to as "tax-sheltered annuities" which include both 403(b)(1) annuities as well as 403(b)(7) custodial mutual funds. Only the employees of public education institutions and 501(c)(3) organizations are eligible to participate in a 403(b) arrangement. Public education institutions include K-12 public schools, community colleges, state colleges and universities. Employees of the Department of Education are also eligible to participate. 501(c)(3) organizations are non-profit groups that are organized for the general public welfare, including such groups as hospitals, charitable and community service groups, religious organizations and other employers who are operated exclusively for "religious, charitable, scientific, literary, educational, or safety testing purposes". This booklet will focus only on 403(b) arrangements in public education institutions.

Eligible Employees

Only the employees of the public school entities that offer educational programs are eligible to participate in TSA investments. Outside service providers such as lawyers, accountants, payroll processing firms, elected tax collectors, or paid school board members, are not eligible to participate (unless they are performing services both as an employee and as an independent contractor). Participation by contracted or leased employees for such functions as housekeeping, food service, transportation and maintenance is less clear because the IRS has not specifically addressed that issue for 403(b) plans; however, it appears that they are not eligible to participate.

Investment Options

Contributions to 403(b) accounts offered in the public schools are limited to annuities, life insurance contracts, which are subject to certain limitations as well as special tax reporting of the "pure" cost of the death benefit, and mutual funds held in custodial accounts. Annuities, either fixed or variable, must be issued by life insurance companies. Such investment contracts are classified as 403(b)(1) arrangements. Investments may also be made in mutual funds and are classified as 403(b)(7) arrangements. The contracts must contain certain provisions to qualify as a 403(b) option.

The contractual language must specify that the account is nontransferable by the employee. The annuity contract and the custodial arrangement must also specify the dollar limit for salary reduction contributions along with stipulations that minimum distributions must be taken at the later of age 70 _ or when the employee stops working and that limit pre-59 _ withdrawals. Such withdrawal restrictions are applicable to salary reduction contributions to annuities, and to both salary reduction and employer contributions to 403(b)(7) custodial mutual funds. Finally the contracts for annuities and the custodial accounts for mutual funds must provide for the direct rollover of "eligible rollover distributions".

Contribution Requirements

There are two basic types of contributions to TSA programs: salary reduction and employer (non-salary reduction) contributions. Salary reduction contributions are voluntary "elective deferrals" that an employee chooses to make. As long as the contributions do not exceed the limits set out in the regulations, they are excluded from the gross income of the employee. Federal and state, where applicable, income taxes are not withheld on the contributions and are not due until distributions are made from the account. Taxes on the earnings are also deferred until distribution. Unlike distributions from other types of qualified retirement savings plans, there is no income averaging permitted on distributions. They are taxed as ordinary income. Employer (non-salary reduction) contributions are those made directly by the employer on behalf of an employee. Such

employer contributions are most frequently made for key personnel or as a funding vehicle to encourage early retirement for selected groups of retiring employees. It is becoming increasingly more frequent for employers to make contributions as retention incentives for key employees since nondiscrimination rules for employer contributions do not apply. Those rules, however, continue to apply to 501(c)(3) employers.

In certain states, there are matching 403(b) plans in public schools and in higher education institutions. The matching programs in public colleges and universities are generally offered to faculty members as an alternative to the state retirement system defined benefit plan.

Payroll Taxes

While 403(b) contributions that are made through a salary reduction agreement are not subject to federal tax withholding, they are subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) up to the applicable compensation ceilings with certain exceptions. For example, public education employees are not subject to the FICA tax in instances where employees do not participate in the social security system. In contrast, employer TSA contributions are not considered to be wages for the purposes of payroll taxes and are thus not subject to FICA, FUTA, or any other payroll tax.

Contribution Limits

The Section 403(b) contribution limits are byzantine in their complexity, although some simplification occurred in legislation enacted in both 1996 and 1997. There are three separate IRS code provisions that determine the contribution limits to TSA programs for an individual employee. The contribution limits are set forth in code Section 403(b)(2) referred to as the exclusion allowance, Section 415(c) referred to as the general limit, and Section 402(g) referred to as the elective deferral cap. These Code provisions contain catch-up rules, special elective limitations for employees of certain eligible employers, rules for aggregating Section 403(b) contributions with contributions and benefit accruals under other plans, and a separate annual limit on salary reduction contributions.

The maximum annual contribution (MAC), often referred to as the MEA or maximum exclusion allowance) is the lessor of the three separate limits. Calculations must therefore be completed under each of the code sections to determine the limits for the maximum employee salary reduction, the limits for the maximum employer contribution and the combined limits for salary reduction and employer contributions.

There is no easy method to calculate these limits. Nor are there any rules of thumb or general guidelines that substitute for the actual calculations. In sum, the rules governing tax-sheltered annuities are complex and the calculations are interrelated. It is therefore virtually impossible for an employee or the employer to determine the legal contribution to a 403(b) plan without the assistance of a person knowledgeable about 403(b) programs with carefully designed worksheets or a computer software program. The contribution limits are described in more detail below. However, the rules are substantially more complex than this brief description permits.

1. *Exclusion Allowance*

The exclusion allowance is a cumulative allowance, described in "short hand" terms as 20% of salary times years of service with the current employer minus contributions made to all retirement plans of that employer for all prior years. Each component of the calculation has very specific IRS rules that apply. For example, salary excludes mandatory pre-tax contributions to such things as the state retirement system defined benefit plan but includes pre-tax contributions to a 403(b) plan.

2. *Section 415(c) Limit*

The Section 415(c) general limit is 25% of compensation to a maximum of $30,000 (as indexed).

3. *Section 402(g) Elective Deferral Limit*

The 402(g) elective deferral limit is $10,000 (as indexed), except for employees who have fifteen

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or more years of service with the current employer. The special cap for those individuals may be as much as $13,000. It is important to note that the elective deferral limits are applicable to the employee, regardless of how many elective deferral arrangements he or she might have, and regardless of whether those deferrals are being made with more than one employer. The term "elective deferrals" refers to contributions that are made at the employee's election from amounts that would otherwise be received and taxed.

The Effect of 457(b) Eligible Deferred Compensation Contributions on the Three Limits

In some school districts, employees make contributions to 457(b) eligible deferred compensation plans. The annual maximum cap on those contributions is $8,000 (as indexed), except for the three tax years ending before the year of normal retirement age when there is a catch up option which may permit annual contributions as much as $15,000. If an employee contributes to both a 457(b) eligible deferred compensation plan and a 403(b) arrangement, the maximum amount that may be contributed in that year is the 457(b) cap or $8,000 unless the catch-up option applies. This is because each dollar contributed to the 403(b) plan reduces the amount that may be contributed to the 457 plan. Employees who have made relatively large contributions to 403(b) plans and other retirement plans in past years may have "used up" exclusion allowance eligibility for current 403(b) contributions; and, will sometimes turn to 457(b) plans as another method of saving on a pre-tax basis.

Correction of Excess Contributions

The correction procedure for contributions in excess of any of the three limits will depend on which of the three limits were exceeded in recent audits. But, regardless of which limit is exceeded the IRS has looked to the employer and not to the employee to pay for under withheld income taxes.

1. *Section 402(g) Elective Deferral Limit*

If the elective deferral cap under Section 402(g) is exceeded, the excess and the earnings attributable to the excess can be distributed to the employee by April 15 of the following year. The maximum salary reduction under Section 402(g) is $10,000 (for 1999, as indexed), which may only be exceeded if a participant qualifies for additional contributions under the special increased cap for those with 15 or more years of service. In that case, the maximum may be as much as $13,000. If the elective deferral is exceeded, and the excess returned, the insurance company or mutual fund vendor will report the distribution as a taxable event with the excess taxed in the year of the excess, and the earnings taxed in the year actually distributed. If the excess is not corrected by April 15 of the following year, then it will be taxed twice - once for the year of the excess, and again in the year distributed. Also, it will have to remain in the account until a distributable event occurs such as the attainment of age 59 _ or separation from service.

2. *Section 415(c) Limit*

If the excess contributions were in violation of the 415(c) limit, the excess amount may be removed if it occurred because of an error in estimating the employee's compensation. Otherwise, the excess remains in the 403(b) account and the employee includes it as taxable income for the year in which the excess occurred. It is corrected in future years by undercontributing to the 403(b) plan. In any year in which a 415(c) excess occurs in a mutual fund custodial account, the employee will also pay a 6% excise tax.

3. *Exclusion Allowance*

There is currently no specific procedure for correction of a contribution in excess of the exclusion allowance. This is ironic since this is the most complex of the limits to calculate and therefore the limit most likely to be exceeded.

If the excess contributions are made to a 403(b)(7) mutual fund custodial account, the employee is subject to the income tax liability and is subject to an additional 6% excise tax. It is also important to note that contributions in excess of any of the three limits will *not* cause the employer's entire plan to be disqualified. Prior to passage of the Small Business Job Protections Act of 1996, excess

deferrals could cause the entire 403(b) arrangement to be disqualified. However, this is no longer the case.

Compensation Definitions

Effective on January 1, 1998, legislation has redefined "compensation" for purposes of the calculation. Under the old rules, compensation for TSA purposes did not include the elective deferrals to the 403(b) plan or 401(k) plan, contributions to a 457 eligible deferred compensation plan, or contributions to a section 125 cafeteria plan. Under, the new definition these contributions are included. This means somewhat simpler calculations, and possibly increased contribution eligibility for many participants. There are other complexities in the definition of compensation. For example, the 403(b)(3) definition of annual compensation is "the most recent period that can be counted as one full year of service", while the 415(c) definition is basically "earnings as paid". This complexity is one more reason why the responsibility for the calculation of the 403(b) contribution limit must be placed with the service providers and/or their agents. Such entities have the technical knowledge of the IRS Code sections and either worksheets or computer software programs that help to perform the maximum annual contribution (MAC) calculation.

Employer Responsibilities

While the employee is technically responsible for contributions which exceed the maximum limits, the experience from IRS audits is that the employer has been required to pay under withheld tax to the federal government that are the result of excess contributions. The employer, who is assessed under with held taxes, can attempt to collect the tax liability from each individual employee who contributed in excess of allowable maximums.
The sample forms in this booklet assume that the employer will require that employees have calculations done by the employee's "annuity or custodial account provider or any other party acceptable to the employer". Copies of such calculations should be provided to the employer to document the contribution limits. Because of the complexity of the contribution limit rules, most public schools do not permit their staff to perform the calculations; however, more and more public schools are requiring that they be done. The correct calculation of the contribution limit is an essential component of a compliance program.

Nondiscrimination Rules

For salary reduction contributions, nondiscrimination rules specifically require that almost all employees be given the opportunity to contribute to a voluntary 403(b) arrangement, provided that they will contribute more than $200 per year. The only employees that can be excluded are those who participate in a Section 457 deferred compensation plan, or any other type of elective deferral arrangement such as another 403(b) plan or 401(k) plan. In addition, non-resident aliens, students performing certain services, or employees who normally work less than 20 hours per week may also be excluded. Despite the clarity of this code section, the IRS has discovered numerous violations of this rule in prior audits.

To comply with the requirement to permit employees, who are willing to contribute at least $200 to participate in the TSA program, the IRS has commented that the employer will need to have at least one provider who will accept this minimal contribution. There are a number of providers who will, by exception, accept contributions that may be less than their normal minimums. It is strongly suggested that the employer make that arrangement. At lease one service provider must agree to accept contributions as low as $200 per year.

In contrast to employee salary reduction arrangements, employer contributions are no longer subject to nondiscrimination rules. This change occurred in the Taxpayer Relief Act of 1997 and, incidentally, does not apply to the 501(c)(3) employer. Under this Act, the public school employer may now choose to contribute to a 403(b) plan on behalf of a key employee or a selected group of employees without the requirement that the plan be offered on a nondiscriminatory basis. This is of special interest in certain situations, such as providing a

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fringe benefit to a key employee, or as a plan to retain experienced teachers, or even to fund early retirement.

Public school entities that are considering employer contributions must take care to construct the plan so that the employee is not in control. For example, the employee must not have the right to receive the amount in cash in lieu of the actual employer contribution in order to avoid the contribution being classified as a salary reduction. The reason, of course, is that salary reduction contributions are limited to the $10,000 or $13,000 cap (1999 as indexed) while employer contributions enjoy the higher $30,000 415(c) cap and are not subject to the payment of payroll taxes.

Salary Reduction Agreement Rule Changes

The Small Business Job Protections Act of 1996 made it permissible to have multiple salary reduction agreements within a tax year effective for the calendar year beginning on January 1, 1996. It also made it permissible to allow salary reduction agreements to affect paychecks that contained earnings for prior years such as a check for accumulated unused sick leave pay. In the event that the IRS would select a year prior to 1996 for audit, however, the violation of the former "one salary reduction agreement per year rules" could still be found to be a plan defect for any year before the rule change.

Title I of ERISA

Most public school district officials know that governmental plans including public education institutions are exempt from coverage under Title I of ERISA. However, there has been some misunderstanding that some school districts must file Form 5500 for 403(b) arrangements under ERISA. One district reported that a firm was hired to evaluate a 403(b) arrangement, with one result being a recommendation that 5500 forms be filed. This is incorrect information. There is no such requirement.

The Internal Revenue Service Audit Program

According to the IRS Examination Guidelines, there are two categories of plan defects. One type of defect affects only the annuity contract or custodial account of the participant. The other kind of defect affects the employer's entire 403(b) program. The latter defect may cause the entire program to lose its tax-deferred status. Some of the defects might fall into both categories. This section is devoted to identifying both types of defects. This section also identifies some of the most common violations, which were discovered during the general audits of non-profit organizations as well as during the actual audits of 403(b) programs.

Plan Defects in the Examination Guidelines

The defects that affect only the account of the participant fall into two categories: those that affect the income tax exclusion for the entire year and those that affect only the income tax exclusion for the portion of the year after the defect occurs. For example, if the annuity contract or custodial account of one participant fails to comply with the minimum required distribution requirements or if contribution limits are exceeded, the income tax exclusion for that participant only is affected. The annuity contract or custodial account of all of the other participants who have accounts through the employer are not affected.

The following defects cause the portion of the employee's contributions not covered by the exclusion allowance to be includible in gross income.

1. Contributions are made in excess of the exclusion allowance. If those contributions are made to a 403(b)(7) custodial account, there is also a potential 6% percent excise tax. The excise tax does not apply to excess contributions made to any annuity contract.

2. Contributions are made in excess of the Section 415 limits. Not only are those contributions taxable, they are counted as amounts previously excludable and have the net effect of reducing the exclusion allowance for future years. And, if made to a 403(b)(7) custodial account, the 6% excise tax will also apply under Code Section

4973 until the excess is corrected.

3. Excess deferrals that are made in excess of the Section 402(g) limits, which are made due to the participant's contributions to the 403(b) contracts of more than one employer. If those excesses are not corrected by April 15 of the year following, they will be included in the participant's gross income for both the year contributed and the year distributed.

4. Participant loans which do not satisfy the rules under Code Section 72(p) are deemed to be distributions and includible in gross income.

5. A plan with "isolated" incidents of failure to satisfy minimum distributions requirements (generally, the later of age 70 _ or actual separation from service) will not suffer plan disqualification; however, the affected employee may be assessed a 50% excise tax on the amount that should have been distributed.

6. For years prior to 1996, an employee who enters into more than one salary reduction agreement within a taxable year, will have all of the contributions made after the second agreement includible in gross income. For years after 1995, multiple agreements are permissible.

The following defects may not only affect the employee's exclusion allowance for the taxable year, but may also affect the entire 403(b) arrangement. They are also the types of defects that could cause the employee's entire 403(b) account to be ineligible for the exclusion allowance including all prior year contributions.

1. The salary reduction agreement is inadequate in its terms. This could include a written agreement, which is not binding and irrevocable, or an agreement, which does not express the contributions as a *salary reduction*, but instead expresses contributions as a *payroll deduction*.

2. The annuity product is purchased from an entity other than an insurance company.

3. The custodial account for mutual funds is offered through an organization other than a bank or other approved nonbank custodian. This defect, incidentally, also applies to the purchase of mutual funds in a 403(b) arrangement that does not have a custodial account at all.

4. Section 403(b) contributions were contributed to a custodial account, which invested in instruments other than regulated investment company stock.

5. Distributions were permitted in violation of the Section 403(b)(11) withdrawal restrictions for annuity contracts or the restrictions described in Section 403(b)(7) for mutual funds.

6. An ineligible employee was permitted to make contributions to the 403(b) program.

7. A 403(b) annuity contract failed to satisfy the ownership nontransferability requirements of Section 401(g).

8. The 403(b) program failed to provide a direct rollover option.

9. There was a pattern of violation of the required minimum distributions.

The plan defects that follow will generally cause the entire 403(b) plan to lose tax-deferred status, a situation, which has the greatest effect on employers and employees.

1. The employer maintaining the 403(b) plan is ineligible to do so.

2. The employer maintaining the 403(b) plan held the contributions in a bank "suspense" account; then purchased annuity contracts as each participant retired. Contributions must be sent directly to 403(b) investment options, and cannot be held in a non-403(b) option.

3. The employer violated the nondiscrimination requirements. In the case of public education institutions, the violation would apply to salary reduction programs where the program is not made available to virtually all employees.

4. For plan years before 1996 only, excess deferrals that exceeded the contribution limits. For plan years after 1995, this particular defect cannot cause the entire plan to be disqualified.

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Most Common Violations

1. Contributions, which exceeded one or more of the three limits: the Section 403(b)(2) exclusion allowance, the Section 415(c) general limit and catch up options, and the Section 402(g) elective deferral caps. This defect was identified in both the general audit program, and in the more recent 403(b) audit program.

2. Violation of the nondiscrimination rules for public school salary reduction programs. The failure to make the 403(b) arrangement available to virtually all employees has been identified as a common defect in the 403(b) audit program.

3. Noncompliance with the distribution restrictions. Salary Reduction contributions to 403(b)(1) annuities and both employer and salary reduction contributions to 403(b)(7) custodial accounts cannot be distributed prior to age 59 _ unless there is a specific qualifying event. There is an exception to that rule for pre-1989 contributions to annuities.

4. Failure to comply with the required beginning date for minimum distributions which is generally, the later of age 70 _ or actual separation from service.

5. Invalid salary reduction agreements, either in terms of those agreements, or in changes allowed. It is important to note that general audits of non-profit organizations, and the 403(b) audit program began when there was only one salary reduction agreement permitted in a tax year. One of the salary reduction agreement defects for years prior to 1996 was the use of multiple agreements in one year.

The ASBO Compliance Project

In July of 1997, individuals representing ASBO and the National Tax Sheltered Annuity Association (NTSAA) began work on the development of materials to educate school officials on IRS requirements for the administration of 403(b) programs. The organizations also wanted to reduce the cost, burden, and complexity in the administration of 403(b) programs. As a result of that joint work, a compliance booklet, including standardized forms, was made available to school officials. The document was finalized after dissemination of an exposure draft that included copies of the standardized forms to every member of ASBO and the NTSAA for review and input as well as service provides who are not members of NTSAA. That extensive input resulted in the development of meaningful guides and forms which include the salary reduction agreement and the service provider agreement which work in unison to provide effective protection to employers and employees and facilitate compliance with IRS requirements.

The experiences of both the employers and the service providers as well as the results of actual audits of school districts have dictated the need for this update. It is anticipated that there will be future updates to the booklet, standardized forms and the training program as Congress adopts new legislation or as the IRS modifies audit programs.

The major issues that have surfaced are primarily a result of the complex structure of the TSA industry. This complexity has caused confusion in such matters as to the entity that can sign the standardized agreements. Such understandings are important since they are critical to securing the protections to the employer and employee that are contained in the service provider and salary reduction agreements.

Who is a Service Provider?

A Service Provider is the entity that produces the annuity product, or, who offers a custodial arrangement in which mutual funds are offered. The protections in the service provider agreement can be most clearly secured with the signature of the service provider. Some service providers for a variety of reasons have expressed an unwillingness to sign the service provider agreement. But, school employers may be able to offer the product of the recalcitrant service provider and still secure the protections in the service provider agreement with the signature of other entities that offer services in the 403(b) marketplace. Such entities might include broker dealers, common remitters, plan administrators, marketing

companies, or independent practitioners (agents).

If the school entity permits other than the service provider to sign the service provider agreement, they must establish that the entity has both the expertise in 403(b) regulations/compliance activities and the financial ability to back up the commitments in the service provider (hold harmless) agreement. This will require that the school entity conduct a "due diligence" review of the financial ability and the technical expertise of the firm. The school employer must be convinced that any signatory to the service provider agreement has the ability to fulfill the commitments in the agreement.

The Service Provider Agreement

The Service Provider Agreement is a contract between the employer and the service provider. It addresses five basic issues.

1) putting money into a 403(b) program;
2) taking money out of a 403(b) program;
3) control of solicitation activities;
4) cooperation in the event of an audit, and
5) indemnification of employees and employers.

In the portion of the contract that deals with putting money into the 403(b) program, the contract permits service providers to offer only investment options that comply with applicable law. Those must be either annuity contracts offered by insurance companies, or custodial accounts that contain the provisions that qualify them as 403(b) options. Further, the contract requires the service provider to furnish the maximum annual contribution calculations to employees upon request. The service provider is required to certify the accuracy of the calculations subject to receipt of accurate information necessary to perform those calculations from the employee.

When money is taken out of the 403(b) program, the contract specifies that the service provider is responsible for the proper reporting and withholding of taxes on distributions made to either employees or their beneficiaries. To meet the requirements regarding transfers and direct rollovers authorized by the employee, the contract requires that the service provider obtain certification from the employee of the reason for the distribution.
The contract requires that the service provider market tax-sheltered annuity or custodial account programs to employees within the specific rules established by the employer, and it requires that employers provide proper notice of those rules to the service providers. This includes any pertinent written directives issued by the employer, provided those directives are not inconsistent with any law.

If the IRS should audit the employer, the contract requires that the service provider extend cooperation to the employer, including the providing of necessary information regarding its products or investment options to the IRS. All of the information maintained or prepared by the service provider must be made available provided that the IRS requires it in the conduct of an audit.

The indemnification for the employer extends to members of the governing board, and to employees for any negligence or failure to meet requirements of the agreement on the part of the service provider. The indemnification also requires the service provider to defend the employer and employees against litigation covered by the indemnification. The service provider would be required to pay actual damages as well as out-of-pocket legal expenses and expenses for judgments covered by the indemnification. The indemnification does not cover any claim, demand, or suit based on erroneous information provided by the employer or the employee.
The service provider agreement needs to be signed by an officer of the company. An agent-employee or sales manager cannot bind the service provider.

The Salary Reduction Agreement

The salary reduction agreement is a contract between the employer, the employee, and the agent or representative of the service provider. Five issues are covered in the agreement.

1) valid and binding contract;
2) putting money into the 403(b) account;

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3) indemnification of the employer by the employee and the practitioner;
4) agreement of the practitioner to follow solicitation procedures, and
5) certain other protections and notices to employees

The salary reduction agreement requires that the employee acknowledge that the agreement is legally binding and irrevocable for amounts paid or made available while the agreement is in effect. This complies with the IRS regulations and virtually eliminates the defects in agreements found by the IRS on some audits. Under the contract, the employee is permitted to terminate the agreement at any time for amounts not paid or available with the termination to remain in effect until the employee submits a new salary reduction agreement.

Consistent with the "new" rules, the agreement permits the employee to modify the terms of the agreement, to change the amount of the salary reduction or to change service providers, subject to the administrative regulations of the employer. Employers are permitted to specify the number of changes that will be allowed in a calendar year. It is important to note that multiple changes in a calendar year should be consistent with the administrative burdens of such changes. Typically, the employer will want to permit more than one change per year; however, most employers will likely not wish to permit "changes at will". It is possible that changes in amounts or in service providers on a quarterly basis would satisfy the flexibility needs of employees. Changes permitted more frequently may create unnecessary burdens for both employers and service providers.

The salary reduction agreement requires employees to provide maximum annual contribution (MAC) calculations for all new agreements or changes in existing agreements. Additionally, the employee is required to provide the MAC annually by November 1 if the salary reduction amount exceeds the basic Section 402(g) limit of $10,000 in 1999 as indexed, or if the employee is making contributions under the catch-up elections or utilizing any of the section 415 special elections. The date of November 1 allows time for correction of excess contributions.

Employees are required, in the agreement, to represent that the calculations are accurate, and to indemnify the employer against claims and actions that may arise from the purchase of the annuity or custodial account. The agent or representative of the service provider is also required to indemnify both the employer and the employee for any claim based on an error in the calculations, unless that error is due to erroneous information provided by either the employer or the employee. The agent or representative is also required to agree to comply with the solicitation rules of the employer.

Finally, the salary reduction agreement makes it clear that the employer is not responsible for the selection or performance of investment options, and it contains useful information about such matters as the naming of a beneficiary and other 403(b) specific regulations.

Implementation Issues and Options

The key to compliance with many of the IRS regulations is to make sure that money going into the program does not exceed the contribution limits for employees. This is accomplished by requiring the employee to provide the MAC calculation to the employer. The employer can then insure that contributions do not exceed the MAC limit provided, of course, that the MAC calculation is correct.

There are two possible sources for an incorrect MAC calculation. The entity that performs the calculation may make an error. Such errors may result from computation mistakes on the part of the entity that actually performs the calculation. Under the Service Provider and Salary Reduction Agreements, such calculation errors are the responsibility of the entity that performs the calculation with the provision that the employee provided accurate and complete information. On the other hand, if the service provider or agent/broker provided an accurate MAC calculation but it is erroneous because of inaccurate or incomplete information provided by the employee, the service provider

and agent/representatives are not responsible.

The most effective strategy then to avoid many of the problems with the IRS as well as to secure protections in the two agreements is to obtain a MAC for all TSA contributions from service providers with the financial assets to make good on any claim resulting from a calculation error. The reality is that to immediately require a MAC for every TSA contribution would be administratively overwhelming to school employers and companies in the 403(b) industry. The suggestion then is to phase in the requirement for a MAC to support every TSA contribution with the priority to contributions that exceed clear guidelines such as the 402(g) $10,000 limit or contributions that use the special catch-up provisions.

Finally, we have previously discussed whether or not to prohibit or evict service providers who will not accept appropriate responsibility or provide overall compliance support, which often includes the unwillingness to sign the standardized agreements and to perform the MAC calculation. If the employer is reluctant to prohibit or evict non-cooperative service providers, then we recommend that some form of due diligence be done for any entity that is retained to perform compliance services for the school employer including, for example, MAC calculations for employees.

The Education Program

ASBO has refined the 403(b) training program that is available through affiliate organizations. ASBO members along with service providers will conduct the training program. The training provides useful information to school business officials on the fundamentals of 403(b) programs as well as guidance on the administration of 403(b) programs. The program also provides guidance on compliance with IRS regulations as well as a detailed review of the compliance booklet including the use of the standardized forms. Finally, the workshops will provide a forum for employers to share information and to get answers to questions. School officials will learn how to effectively protect the interests of both the employer and the employee in the event of an audit by the IRS.

Compliance Checklist

The attached checklist is intended to provide additional guidance to school district personnel who are responsible for implementing the proper procedures in operating a 403(b) program.

References

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About the Author

Denny G. Bolton, Ph.D. is Chief Business Official (CBO) in the Owen J. Roberts School District, Pottstown, PA. Dr. Bolton is a member of ASBO's Editorial Advisory Committee and has served as president of both the Pennsylvania Association of School Business Officials (PASBO) as well as the Association of School Business Officials (ASBO) International. In 1997, he chaired the Joint ASBO-NTSAA Committee that developed the model agreements (the Service Provider Agreement and the Salary Reduction Agreement). He is also the author of the first edition of this article titled, *Section 403(b) Program Administration and Audit Compliance*.

Service Provider Agreement
for
§403(b) Retirement Programs (non-ERISA)

NAME OF SCHOOL DISTRICT _____
(THE "EMPLOYER")

Employer certifies that it is an eligible employer to sponsor a 403(b) program and accepts all liability for this determination.

Effective on the date hereof, the Service Provider identified below agrees, in consideration of being designated an approved Services Provider, to the terms and conditions set forth herein with respect to purchases, sales, transfers or other transactions related to the servicing of 403(b) annuity contracts and/or custodial accounts that are processed through the Service Provider.

Employer and Service Provider agree:

1. Service Provider, upon the request of any Employee, shall provide such Employee a Maximum Annual Contribution (MAC) calculation in accordance with state and federal income tax statutes, rules and regulations (Applicable Law). Furthermore, Service Provider shall certify to the Employer and Employee the accuracy of the calculation, as performed by Service Provider or its agent, based on the accuracy of information provided by the Employee.

2. Service Provider shall offer only custodial accounts or annuity contracts, the terms of which comply with the provisions of Applicable Law. Such custodial accounts and/or annuities shall be available for purchase by the Employer for any eligible Employee.

3. Service Provider shall be responsible for reporting and withholding taxes on distributions it makes directly to Employees and/or their Beneficiaries, as appropriate. For annuity or custodial accounts that permit Employee-directed requests through the Service Provider, the reason for the distribution shall be certified by the Employee so that the restrictions of Applicable Law regarding allowable transfers, direct rollovers, and rollovers are met. With respect to withdrawals, the Service Provider may rely upon the information received from the Employee, Employer or prior service provider in the event of a transfer.

4. Service Provider agrees that it shall, upon reasonable advance notice, comply with all pertinent written directives regarding the solicitation of Employees to the extent compliance is not inconsistent with any law.

5. In the event of an income tax audit of Employer, Service Provider agrees that it shall extend its cooperation in providing necessary information to the Employer regarding Employees in the products provided by Service Provider provided such information was maintained or prepared by Service Provider in providing such products.

6. Service Provider agrees to indemnify and hold harmless the Employer, including any individual member of the governing board, and Employees from every claim, demand or suit which may arise out of, be connected with, or be made by reason of the negligence of the

Service Provider or failure of the Service Provider to meet the requirements of this Agreement. Notwithstanding the preceding sentence, this indemnification shall not cover any claim, demand, or suit based on erroneous information provided by the Employer or Employees or their willful misconduct or negligence. Service Provider, at its own expense and risk, shall defend, or at its option settle, any court proceeding that may be brought against the Employer, including members of the governing board, and Employees on any claim, demand or suits covered by this indemnification, and shall satisfy any judgment that may be rendered against any of them with respect to any such claim or demand, provided that Employer notifies Service Provider, in writing, within twenty (20) business days of receipt of such claim or demand. Service Provider's liability hereunder shall be limited to actual damages and out-of-pocket legal fees and expenses only.

7. This Agreement may be modified, amended or terminated by Employer or Service Provider upon thirty (30) days written notice to the other party, provided that no such modification, amendment or termination shall affect any liability incurred by Service Provider prior to such modification, amendment or termination.

8. This Agreement supersedes all prior agreements between the Service Provider and Employer.

Service Provider _____

_____

Dated

_____

By

_____

Title *Authorized Officer of Service Provider*

Employer _____

_____

Dated

_____

By

_____

Title *Authorized Signature of Employer*

Salary Reduction Agreement for §403(b)(1) and §403(b)(7) Programs

IMPORTANT NOTICE

Before you sign: Read the important information on the reverse side of this form. Each Employee who initiates or changes contributions to a 403(b) program shall, at such time, provide the Employer with a copy of his/her maximum annual contribution (MAC) as calculated by the Employee's chosen annuity or custodial account provider or any other party acceptable to Employer. For each Employee contributing $10,000 or more or utilizing the "catch-up provisions" or the special elections allowed by the Internal Revenue Code, a MAC calculation shall be required annually. A copy of such MAC calculation shall be provided to Employer by November 1 of each calendar year in which the "catch-up provisions" or "special elections" are utilized.

Part 1. Employee Information:

_____
Employee Name

_____
Employee Social Security Number

_____
Employee Address

Part 2. Contribution Information *(Select all that apply)*

- ☐ **Initiate new salary reduction**
  Please deduct the amount of $_____ or _____% per pay.
- ☐ **Change salary reduction**
  This is notification to change the amount of my TSA salary reduction from $_____ or _____% to $_____ or _____%.
- ☐ **Change Service Provider**
  This is notification to change my Service Provider (indicate amounts in Part 3) from _____ to _____
- ☐ **Discontinue salary reduction**
  Please discontinue my TSA salary reduction with the following Service Provider:
  _____
- ☐ **Employee is utilizing catch-up provision/special elections**

Implementation Date: Salary reduction instructions shall be implemented in accordance with Employer's administrative schedule.

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Part 3. Service Provider

	$ or % of Compensation per reduction	Service Provider
1.	_____	_____
2.	_____	_____
3.	_____	_____
4.	_____	_____

Part 4. Agreement

The above named Employee agrees to modify his/her salary as indicated above. Employer agrees to contribute this amount on Employee's behalf into the annuity or custodial accounts selected by Employee. It is intended that the requirements of all applicable state or federal income tax rules and regulations (Applicable Law) will be met. The Employee understands and agrees to the following:

1) this Salary Reduction Agreement is legally binding and irrevocable with respect to amounts paid or available while this agreement is in effect;
2) this Salary Reduction Agreement may be terminated at any time for amounts not yet paid or available, and that a termination request is permanent and remains in effect until a new Salary Reduction Agreement is submitted; and
3) this Salary Reduction Agreement may be changed with respect to amounts not yet paid or available in accordance with the Employer's administrative procedures.

Employee is responsible for determining that the salary reduction amount does not exceed the limits as set forth in Applicable Law. Furthermore, Employee agrees to indemnify and hold Employer harmless against any and all actions, claims and demands whatsoever that may arise from the purchase of annuities or custodial accounts for Employees in amounts in excess of contribution limits as defined under Applicable Law except where an MAC was calculated by Service Provider based on accurate information provided by Employee.

Part 4: Agreement (continued)

Employee acknowledges that Employer has made no representation to Employee regarding the advisability, appropriateness or tax consequences of the purchase of the annuity and/or custodial account described herein. Employee agrees Employer shall have no liability whatsoever for any and all losses suffered by Employee with regard to his/her selection of the annuity and/or custodial account; its terms; the selection of the insurance company or regulated investment company; the financial condition, operation of or benefits provided by said insurance company or regulated investment company; or his/her selection and purchase of shares of regulated investment companies. Nothing herein shall affect the terms of employment between Employer and Employee. This agreement supersedes all prior salary reduction agreements and shall automatically terminate if Employee's employment is terminated.

IMPORTANT INFORMATION

1. Employer does not choose the annuity contract or custodial account in which your contributions are invested.
2. Employees are responsible for setting up and signing the legal documents to establish your annuity contract or custodial account. However, in certain group annuity contracts, the Employer is required to establish the contract.
3. In order to receive the expected tax results, Employees are responsible for investing in annuity contracts or custodial accounts that meet the requirements of Section 403(b) of the Internal Revenue Code.
4. Employees are responsible for naming a death beneficiary under annuity contracts or custodial accounts. This is normally done at the time the contract or account is established. Beneficiary designations should be reviewed periodically.
5. Employees are responsible for all distributions and any other transactions with Service Provider. All rights under contracts or accounts are enforceable solely by Employee, Employee beneficiary or Employee's authorized representative. Employee must deal directly with Service Provider to make loans, transfer to different contracts or custodial accounts, begin distributions, or any other transactions.
6. Employees are responsible for determining that salary reductions do not exceed the allowable contribution limits under Applicable Law. You are strongly encouraged to have a maximum annual contribution (MAC) calculation performed by the chosen Service Provider.

Part 5. Employee Signature

I certify that I have read this complete agreement and that my salary reductions do not exceed contribution limits as determined by Applicable Law. I understand my responsibilities as an Employee under this Program, and I request that Employer take the action specified in this agreement. I understand that all rights under the annuity or custodial account established by me under the Program are enforceable solely by me, my beneficiary or my authorized representative.

_____

Employee Signature *Date*

FOR SALES AGENT/REPRESENTATIVE COMPLETION

Part 6. Acknowledgement and Representation of Sales Agent/Representative

I agree to comply with all pertinent written directives regarding the solicitation of Employees. I will provide a maximum annual contribution (MAC) calculation for each Employee who initiates or changes contributions. A MAC calculation will be provided annually for Employee contributing $10,000 or more or utilizing "catchup provisions" or the special elections. Furthermore, I agree to indemnify and hold harmless the Employer, any individual member of the governing board and the Employee participating in the 403(b) Program against any claims based on an error in the MAC calculation that I provided, except where the error is based upon erroneous information provided by Employer or Employee. *(Please Print)*

Agent Name _____

Phone _____

Address _____

Signature _____ Date _____

Part 7. Employer Signature

Employer hereby agrees to this Salary Reduction Agreement.

Employer Signature _____

Title _____ Date _____

Compliance Checklist
for
§403(b) Tax Deferred Retirement Plans
for
Public School Organizations

The following checklist is intended to provide additional guidance to school personnel who are responsible for the implementation of the proper procedures for the operation of a 403(b) Tax Deferred Retirement Plan for public school organizations. Items in boldface type are required for compliance.

Employer Preparation:

- ☐ Adopt the Service Provider Agreement and the Salary Reduction Agreement.
- ☐ Adopt written rules and regulations, including the number of salary reduction agreements permitted, whether employees are permitted to contribute to more than one service provider, the deadlines for receipt of salary reduction agreements prior to actual reductions, solicitation rules, and the **monitoring of elective deferral limitations**.
- ☐ **Permit the participation of all employees in the TSA program (except certain categories, which may be excluded.)**
- ☐ Designate and train personnel to manage the compliance processes.
- ☐ Prepare an explanation of the procedures to effect compliance with IRS requirements for employees.
- ☐ Develop procedures to deal with service providers and agents/representatives who refuse to comply with the provisions of the Service Provider Agreement and the Salary Reduction Agreement. For example, eviction or termination of payroll reduction privileges.

Implementation:

- ☐ Distribute the Service Provider (hold harmless) Agreement to the service providers.
- ☐ Distribute rules to service providers, agents/representatives, and employees.
- ☐ Require service providers to also distribute rules to agents/representatives.
- ☐ Distribute letter to employees explaining that the reason for the change in procedures is to comply with legal requirements of the Internal Revenue Service (IRS) as well as to protect both the interests of the employer as well as the employee.
- ☐ Notify service providers who refuse to execute the Service Provider Agreement that their payroll privileges are terminated, with specific information regarding current contributions. For example, will current contributions be permitted to continue and, if so, for how long?

Systems and Administration:

- ☐ **Establish systems and procedures to monitor the requirement that contribution calculations be provided and signed by the employee and the agent/representative.** The calculation of the maximum annual contribution (MAC) should be attached to the Salary Reduction Agreement.
- ☐ Establish procedures for handling violations such as the failure of agents/representatives to provide the MAC calculation or to conform to the rules for solicitation.
- ☐ Establish system for approval of new service providers, including the execution of the agreements.

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